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	Yen Surges To Record Highs	1
	Financial Affairs Update	3
IN THIS ISSUE:	The Source Of International Trade Imbalances	5
	Reagan Orders Retaliation For Japan's Semiconductor Trade Practices	7

Yen Surges To Record Highs

Despite the February 22 agreement calling for exchange rate stability, the dollar resumed its slide in late March, falling to a post-World War II record low. The decline, which followed two months of relatively stable currency values, came despite massive joint intervention in exchange markets by the central banks of the major industrial countries. The volatility spilled over into world financial markets, as stock and bond prices plunged amid fears of higher U.S. interest rates. As of March 25, the yen had risen 70 percent on a trade-weighted basis since the end of February 1985 (see Table).

The pressure on the dollar was the first test of February's Group of Seven agreement stating that exchange rates were roughly consistent with underlying economic fundamentals (see JEI Report No. 8B, February 27, 1987). To maintain currency stability the central banks of the United States, Japan, West Germany, France and Britain purchased an estimated \$6 billion during the week of March 23-27. Even this large-scale intervention was unable to reverse the dollar's downward trend in global currency markets, which trade as much as \$250 billion a day.

Changes in Yen Relative to Currencies of Major Trading Partners

<u>Currency of*</u>	<u>Share of Japan's trade in 1986**</u>	<u>Percentage change from end of February 1985 to March 25, 1987</u>
United States	32.6%	73.9%
Republic of Korea	4.7	75.8
China	4.6	128.4
West Germany	4.4	-4.3
Taiwan	3.7	52.1
Australia	3.6	78.6
Canada	3.1	64.9
Britain	3.0	18.5
Indonesia	3.0	162.3
Hong Kong	2.5	73.9
Saudi Arabia	2.4	82.5
United Arab Emirates	2.1	74.0
Singapore	1.8	64.5
Malaysia	1.7	69.5
Soviet Union	1.5	28.0
France	1.5	3.8
Switzerland	1.3	-6.3
Netherlands	1.1	-4.9
Thailand	1.0	60.3
Belgium	0.9	-1.9
Trade-weighted average		70.0

*Since March 1987 inflation rates are not available for most countries, all percentage changes are calculated using nominal exchange rates. Admittedly, it is real, not nominal rates, that affect trade flows. For the countries listed above, though, changes in nominal exchange rates have closely paralleled changes in real rates.

**The top 20 trading partners listed above accounted for 80.6 percent of Japanese trade (exports plus imports) in 1985. The weighted average change in the exchange rate is based on 1985 and 1986 shares of trade.

Source: International Monetary Fund and the Wall Street Journal

Traders attributed part of the dollar's decline to seasonal factors. It is common for Japanese exporters to sell dollars to repatriate profits prior to the end of their fiscal year on March 31. Market participants also pointed to Treasury Secretary James Baker's comment March 22 that Washington had no target for the dollar, which seemed to contradict the February agreement. Some observers speculated that the United States had repudiated the pact in frustration at Japan's failure to adopt policies to stimulate its economy. In congressional testimony March 25, though, Mr. Baker held that he supported the accord and rejected any suggestion that Japan and West Germany had failed to fulfill their commitments to boost their economies.

Despite an estimated \$2 billion in purchases by the Bank of Japan, the dollar fell to a record closing low of Y146.2=\$1.00 on March 30. The decline was attributed to the dispute over semiconductor trade and concerns that the U.S. decision March 27 to retaliate against Japanese electronic exports could escalate into a full-scale trade war (see article in this issue).

Business leaders reacted with alarm to the yen's rise above the Y150 level. According to the daily Nihon Keizai Shimbun, a rise from Y150 to Y140=\$1.00 would lower Japan's real growth rate in FY 1987 (April 1, 1987-March 31, 1988) by 0.6 percentage point. The Nikkei index of 225 stock prices suffered its second-worst drop on record March 30, led by declines in the stocks of export-oriented companies. Keidanren called its first emergency meeting in a more than a decade to discuss the yen's latest surge, which chairman Eishiro Saito termed a "shock that will shake the very foundations of the Japanese economy." There were also numerous calls for the government to stimulate domestic demand.

Finance Minister Kiichi Miyazawa has urged that Tokyo move quickly to stimulate the economy. The Economic Planning Agency plans to finish the outline of a stimulus package prior to the prime minister's trip to the United States on April 29. Some influential Liberal Democratic Party leaders want the package to mark a fundamental change in fiscal policy.

Randall S. Jones

Financial Affairs Update

Amidst the chaos caused by the yen's continuing rise against the dollar, there are numerous signs that Japan's financial firms are prospering. At the same time, financial institutions and monetary policymakers are restructuring domestic markets and becoming more involved in markets abroad, just as foreign financial companies are finding more opportunities in Tokyo.

According to a survey by the Nihon Keizai Shimbun, the pretax current profits of 135 financial institutions for the year ending March 31, 1987 will total just under Y4.6 trillion (\$30.7 billion at Y150=\$1.00), a gain of 36 percent. In contrast, the manufacturing sector expects a 24 percent decline in profits to just under Y4.2 trillion (\$28 billion), the second annual drop in a row. The shift in Japan's economic structure is clear: while the manufacturing sector accounted for half of total industrial profits in FY 1984, its contribution is expected to drop to 34 percent in fiscal 1986. Conversely, the nonmanufacturing segment will gain another 10 points to contribute 66 percent of all profits, with financial firms holding a 37 percent share.

The ascendancy of financial firms is underscored by the appearance of Japan's Big Four securities houses in the top 10 corporations ranked by pretax profits. Although Toyota Motor Corp. held on to first place, Nomura Securities Co., Ltd. (second), Daiwa Securities Co., Ltd. (fifth), Nikko Securities Ltd. (eighth) and Yamaichi Securities Co., Ltd. (tenth) displaced such industrial giants as Hitachi, Ltd., Nissan Motor Co., Ltd. and Matsushita Electric Industrial Co., Ltd. The brokerage houses benefited from both the tremendous surge in foreign investment and the dramatic rise of the Tokyo stock market.

& Co. and Salomon Brothers Inc. have opened such accounts. As of July 1986 the foreign syndicate members had only successfully bid to underwrite 0.07 percent of outstanding Japanese government bonds, estimated at ¥136.3 trillion (\$908.7 billion). The syndicate leadership is also considering raising the share of the primary 10-year bond market allocated to foreign firms from 1.19 percent to 5.7 percent. Finally, MOF is planning to issue six-year bonds to bolster the medium-term market against competition from the short-term bond market, which offers instruments with maturities of two, three and four years.

Over-the-counter sales of government bonds at most of Japan's 20,000 post offices will begin October 1 under an agreement between the Ministries of Finance and Posts and Telecommunications. The two have set a limit of ¥5 million (\$33,333) for primary purchases in order to limit the competition between private bond outlets and the post offices. Secondary transactions, however, will be unregulated. Funds currently held in tax-exempt savings accounts cannot be directly converted to bonds, and while interest earned on bonds may be paid directly into an ordinary savings account, the post offices may not create a financial instrument combining bonds with fixed deposits. The postal savings system has been allotted ¥2 trillion (\$13.3 billion) worth of bonds in fiscal 1987 and will be permitted to use any unpurchased bonds as collateral to make loans of up to ¥2 million (\$13,333) per individual. When this change goes into effect, bond markets will undoubtedly show another spurt of activity.

The Ministry of Finance may be on the verge of allowing Japanese firms to invest in foreign financial futures. While trading in domestic futures has been allowed for about 18 months, the volume has already surpassed trades in Treasury bond futures on the Chicago Board of Trade. To date, Japanese financial institutions have only dabbled in foreign futures but have been pressuring MOF to lift its restrictions. MOF is considering limiting foreign futures trading to those based on a Japanese firm's own instruments, but Americans are hopeful that the ministry will permit trading in Treasury bond futures because of the significant amount of Japanese investment exposed to bond market fluctuations. MOF has not announced a date for its decision.

Finally, MOF has decided to allow U.S. banks to open securities subsidiaries in Japan under certain conditions. The parent bank's stake in the subsidiary must be no greater than 50 percent and the remaining equity must come from a non-financial institution. Tokyo has allowed 11 European universal banks to open securities units, and several U.S. banks, including Morgan Guaranty Trust Co., Bankers Trust Co., Chemical Bank and Manufacturers Hanover Trust Co., have been negotiating with the ministry for similar access. While no date for granting the American firms the necessary licenses has been set, MOF is touting the move as another important step toward liberalization.

Jon Choy

The Source Of International Trade Imbalances

Economists have increasingly focused on Japan's high saving rate and its shrinking government budget deficit as the underlying causes of its huge current account surplus. According to a well-known national income accounting concept, a nation's current account balance equals its private-sector balance (saving minus investment) plus the government balance. In Japan's case, the failure of business investment and the public sector to absorb household savings has left a surplus to invest abroad. The reverse side of this capital outflow is a large trade surplus.

Japan's current account surplus ballooned from \$4.8 billion in 1981 to \$86 billion last year. The U.S. balance has moved in the opposite direction, swinging from a \$6.3 billion surplus in 1981 to a \$140.6 billion deficit in 1986. Personal savings in this country have been insufficient to fund both private investment and large government deficits. After four years of huge capital inflows and matching trade deficits, protectionist pressures in Washington have surged, leading to friction with the nation's major trading partners, particularly Japan.

If Japan were the source of the unprecedented international imbalances, one would expect to see an across-the-board improvement in its trade position. Tables 1 and 2 support the conclusion that the United States is primarily responsible, although lower oil prices also played an important role. The United States and the Organization of Petroleum Exporting Countries accounted for more than three-fourths of the increase in Japan's trade surplus between 1981 and 1986. Trends in its trade balance with the rest of the world, meanwhile, have been mixed. Larger surpluses with the European Community and the newly industrialized countries of Asia have been partially offset by a deterioration in the balance with Latin American and Communist bloc nations.

The U.S. trade position, in contrast, deteriorated with every trading region except OPEC between 1981 and 1986. While Japan accounted for the largest share of the \$130 billion rise in the U.S. trade deficit, the European Community, the newly industrialized countries, Canada and Latin America also played important roles. In addition to the strong dollar resulting from the domestic saving-investment imbalance, the rise in the U.S. trade deficit reflects the Third World debt crisis and the faster rate of growth in this country than in most of its trading partners.

Randall S. Jones

Table 1: Japan's Trade Balance, 1981 and 1986

(in billions of dollars, exports f.o.b., imports c.i.f.)

	<u>1981</u> <u>Trade</u> <u>balance</u>	<u>1986</u> <u>Trade</u> <u>balance</u>	<u>Increase</u> <u>in</u> <u>surplus</u>	<u>Share of</u> <u>increase in</u> <u>Japan's surplus</u>
United States	\$13.3	\$51.4	\$38.1	51.5%
OPEC*	-32.1	-12.4	19.7	26.6
European Community	10.3	16.7	6.3	8.6
Newly industrialized countries**	12.3	17.5	5.2	7.1
China	-0.2	4.2	4.4	5.9
Other developed countries	-1.3	0.8	2.1	2.9
Communist bloc***	2.0	1.6	-0.4	-0.5
Latin America	3.8	3.3	-0.5	-0.7
Other developing countries	0.5	-0.5	-1.0	-1.3
Total	8.7	82.7	74.0	100.0

*Excludes Venezuela and Ecuador.

**Includes Taiwan, Korea, Hong Kong and Singapore.

***Excludes China.

Source: Ministry of Finance

Table 2: U.S. Trade Balance, 1981 and 1986

(in billions of dollars, exports f.a.s., imports c.i.f.)

	1981 <u>Trade</u> <u>balance</u>	1986 <u>Trade</u> <u>balance</u>	Increase in <u>surplus</u>	Share of increase in <u>U.S. deficit</u>
Japan	\$-18.1	\$-58.6	\$40.5	31.1%
European Community	8.7	-26.4	35.1	26.9
Newly industrialized countries*	-7.0	-30.8	23.8	18.3
Canada	-7.3	-23.3	16.1	12.3
Latin America	1.3	-13.0	14.3	11.0
Other developed countries	5.3	-5.1	10.4	8.0
Communist bloc***	4.2	-2.3	6.5	5.0
Other developing countries	2.9	-2.8	5.7	4.4
OPEC**	-29.7	-7.4	-22.3	-17.1
Total	-39.6	-169.8	130.2	100.0

*Includes Taiwan, Korea, Hong Kong and Singapore.

**Excludes Venezuela and Ecuador.

***Excludes China

Source: Department of Commerce

Reagan Orders Retaliation For Japan's Semiconductor Trade Practices

The Reagan administration has made good on its January 28 threat to retaliate against Japan if Tokyo did not quickly implement the semiconductor settlement agreement hammered out this past July. Asserting that Japanese manufacturers were still dumping in third markets and that American suppliers did not have any better access to the Japanese market now than last fall, the president announced March 27 that the United States would slap 100 percent penalty tariffs on \$300 million worth of Japanese-made products to offset the sales lost by this country's semiconductor industry because of unfair Japanese trade practices. Japanese government officials made an eleventh-hour attempt to convince the White House that Tokyo was doing everything possible to live up to its side of the pact, but this effort did not produce the last-minute deal that had obviated retaliation by Washington in all the other equally high-profile trade clashes between the United States and Japan.

Although Mr. Reagan's decision to go the trade sanctions route was unprecedented in bilateral relations, few Washington observers were surprised by the move. They argue that the White House simply had too much at stake politically to back down after threatening retaliation. For starters, the administration spent a year trying to work out a way to settle the unfair trade practices petition filed by the Semiconductor Industry Association under Section 301 of the 1974 Trade Act and the dumping complaints brought against Japanese manufacturers of 256K DRAMs (dynamic random access memories) and EPROMs (erasable programmable read-only memories). Then when an agreement was in hand, U.S. trade policymakers went to great lengths to assure skeptical American merchant semiconductor manufacturers that their Japanese competitors were